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Recent Developments in Executive Compensation and Employment Tax

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Agenda

- Correcting Common Section 409A Failures
- Recent Developments under Code Section 162(m)
- FICA Taxation of Nonqualified Deferred Compensation
- Tax Reform Proposals

CORRECTING COMMON SECTION 409A FAILURES

Section 409A: General Requirements

- Section 409A covers all forms of deferred compensation (unless specifically excluded from coverage) and prescribes general rules for:
  - Elections to defer compensation
  - Payment of deferred compensation
  - Mandatory six-month payment delay for payments to "specified employees" following termination
  - Reporting and withholding of deferred compensation
- Even if plan documents are compliant, operational failures may result in additional taxes and interest
- Calculating taxes and penalties is a mess
- Recent IRS audit efforts have focused on top 10 officers

Section 409A: Consequences of a Violation

- Current taxation of vested deferred compensation under the plan
- 20% penalty tax
- Premium interest tax equal to federal underpayment plus 1% back to vesting date, on all vested amounts under plan
- Under plan aggregation rule applicable to operational failures, the "plan" may include all arrangements of the same type covering the same service provider
  - Example: Parachute payment of $100,000 paid to executive A immediately upon termination of employment in violation of 6 month rule. Executive A vested in SERP with PV of $4 million. If failure not corrected, and assuming parachute payment and SERP in same aggregated plan, 409A tax and penalties triggered on $4.1 million.
  - Aggregation rule does not apply to stock options or stock appreciation rights

Section 409A: IRS Correction Programs

- IRS Notice 2008-113 (issued December 2008) is the only sanctioned method for correcting 409A operational failures
  - IRS Notices 2010-6 and 2010-80 allow for the correction of plan document failures, and include important updates to Notice 2008-113
- Different rules apply depending on how long it takes to correct the failure
- The longer it takes to correct, the more significant the tax and reporting consequences
- Correction under the Notice is not permitted after the end of the second year following the year in which the error occurred!

SECTION 409A: IRS CORRECTION PROGRAMS

- Advantages of Corrections Program
  - Limits the violation to amounts directly involved in the failure; no other plans affected
  - No premium interest; in some cases no additional taxes at all
  - IRS claims that employers are not more likely to be audited after using the program
- Limitations of Corrections Programs
  - Only specified types of failures can be corrected
  - Can't correct operational failures more than 2 years old
  - Detailed reporting on tax returns filed for correction year (exception for employee's tax return for operational failure corrected in failure year)
  - Operational failures are not corrected unless employer takes commercially reasonable steps to prevent recurrence; need good story for repeat offenses
  - Early payments cannot be corrected if the employer experienced a substantial financial downturn during the year of payment

Section 409A: Common Deferral Errors

- Definition of compensation not administered correctly
- Mid-year enrollment for newly eligible participants
  - May only defer amounts earned following enrollment; bonuses may be pro-rated
- Bonus deferral elections often apply to amounts paid in the second year after the election is made
- May be able to correct errors before year-end without using the corrections program

Section 409A: Common Payment Errors

- Identifying Section 409A Separation from Service
  - Reduction in hours
  - Leave of absence
  - Transfer to affiliates, especially if the affiliate is on a different payroll system
  - Ongoing consulting work after termination of employment
  - Rehire following termination
  - Acquisitions & dispositions

Section 409A: Example of Correction

- Employee A is owed $100 from deferred compensation plan on separation from service in 2014. By mistake, the $100 is not paid in 2014.
- Correction under Notice 2008-113: Employer pays the $100 to the employee. The specific mechanics of the correction (tax, interest, earnings, reporting) will vary based on:
  - The amount of the missed payment
  - Whether the employee is an "insider"
  - The year in which the correction is made
- Alternative Correction: No 409A failure occurred. Employee A was in constructive receipt of the payment following separation. Appropriate correction is to issue an amended Form W-2.

RECENT DEVELOPMENTS UNDER CODE SECTION 162(M)

Section 162(m): General Rule

- Compensation paid to a "covered employee" in excess of $1 million generally is not deductible by the corporation
  - Certain types of compensation are disregarded
  - Does not affect employee's tax treatment
- Applies only to public companies
- Covered employees include the CEO, and the four highest paid officers for SEC disclosure purposes
  - Notice 2007-49: Generally does not include the CFO

Section 162(m): Performance Pay Exception

- Must be granted by a compensation committee consisting solely of two or more outside directors
- Compensation may be paid only upon the attainment of one or more pre-established, objective performance goals
  - Outcome of performance goals must be substantially uncertain at the time the award is issued
  - A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal has been achieved
  - The performance goal must be established in writing no later than 90 days after the start of the performance period, and after no more than 25% of the performance period has elapsed
  - Compensation Committee may have discretion to decrease an award, but not to increase the award
- The award must preclude discretion to increase the amount payable following the 90-day and 25% deadlines set forth above
- Before any payment is made, the compensation committee must certify that the goals have been satisfied

Section 162(m): Performance Pay Exception

- Shareholders must approve the "material terms" of awards to covered employees. These include:
  - The employees or categories of employees that are eligible to receive the compensation;
  - The business criteria upon which the performance goal(s) may be based (but not specific targets); and
  - Maximum amount that could be paid to any employee, or the formula used to calculate compensation if the performance goal is reached. For equity awards, a share limit will suffice.
- Mechanics of shareholder approval
  - Separate shareholder vote
  - No deduction if the awards would be paid anyway
  - Re-approval required every five years if the Compensation Committee has the authority to change the targets under a performance goal

Section 162(m): Recent Developments

- Common Failures
  - Performance requirements waived in the event of retirement, or involuntary or "good reason" termination
  - Payments made before the performance period ends
  - Performance goals adjusted to reflect changed circumstances without specific plan language that allows for the change
  - Use of performance metrics that were not approved by shareholders
  - Failure to properly document performance goals
  - Compensation committee includes non-outside directors
  - Failure to obtain shareholder re-approval
  - These are the simple rules, not the hard ones!

Section 162(m): Recent Developments

- Lawsuits
  - Plaintiffs allege that plans failed to qualify for the performance-based exemption under Section 162(m)
  - Suits allege breach of fiduciary duty, waste, and unjust enrichment
  - Seek recovery of compensation, liability for directors and executives, and injunctions against future payments
  - Several cases have (partially) survived motions to dismiss, resulting in significant settlements that include attorneys' fees
    - Courts dismissed direct claims because of the lack of direct economic harm, but allowed derivative claims to proceed.
  - Small likelihood of success on the merits, but companies still face litigation costs and negative publicity

Section 162(m): Recent Developments

- Section 162(m)(6)
  - Reduces limit from $1M to $500K
  - Applies to "covered health insurance providers," subject to controlled group aggregation rules
  - Generally applies to all service providers, including officers, employees and directors
  - No performance pay exception
  - Different timing rules for taking nonqualified deferred compensation into account
  - May be applied more broadly as part of future tax reform

Section 162(m): Recent Developments

- Revenue Ruling 2012-19
  - Dividends and dividend equivalents are separately subject to performance requirements
  - Good: Vest and become payable only if and when performance goals are satisfied for the underlying restricted stock/RSUs
  - No good: Paid at the same time dividends are paid, without regard to performance goals
  - Payment rule also must satisfy Section 409A, which can be tricky!

Section 162(m): Recommendations

- Reserve the right to issue awards that are not deductible under Section 162(m)
- Make sure plan documents comply with all requirements for performance-based compensation
- "Umbrella" plan design may facilitate Section 162(m) compliance and limit the need for re-approval, but large maximum awards may raise red flags for shareholders
- Separate bonus plan for outside directors

FICA TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

Section 3121(v)(2): General Rule

- Code Section 3121(v)(2) provides that nonqualified deferred compensation generally is subject to FICA tax on the later of:
  - The date the underlying services are performed, or
  - The date the compensation is no longer subject to a substantial risk of forfeiture
  - For non-account balance plans, FICA taxation may be delayed to the extent the amount deferred is not "reasonably ascertainable;" alternatively, earlier inclusion is permitted, with a subsequent true-up
- This is a pro-taxpayer rule because employees' other earnings are more likely to exceed the Social Security wage base when they are still performing services for their employers
- To the extent FICA tax is paid in accordance with this rule, payments from nonqualified deferred compensation plans are not subject to FICA tax
  - Otherwise, benefits and related earnings are subject to FICA when paid

Section 3121(v)(2): Treatment of Earnings

- For account balance plans, earnings attributable to an amount that has been taken into account for FICA purposes are not subject to FICA tax, as long as earnings are based on either
  - A "reasonable rate of interest" or
  - A "predetermined actual investment"
- For non-account balance plans, earnings are not subject to FICA as long as the amount taken into account is determined using "reasonable actuarial assumptions"
- Earnings in excess of these limits are subject to FICA tax as they accrue
- If the employer fails to take the excess earnings into account, all benefits attributable to earnings in excess of AFR are subject to FICA tax when the benefits are paid

SECTION 3121(v)(2): COMMON ERRORS

- "Unreasonable" fixed interest rates
  - This is fairly typical for older account balance plans
- Failure to take employer contributions into account
  - Unlike company contributions to 401(k) plans, company contributions to nonqualified plans are FICA wages
- Failure to tax earnings generated before benefits are "taken into account" for FICA purposes
  - E.g., earnings are credited at year-end, but are calculated as if they were earned ratably throughout the year
- Failure to tax retirement-age vesting of RSUs

Section 3121(v)(2): Recent Court Decision

- In *Davidson v. Henkel Corp.* (E.D. Mich., 1/6/15), a federal district court ruled that Henkel violated ERISA by failing to timely withhold FICA taxes from employees' nonqualified deferred compensation benefits
  - The court held the company liable under ERISA for the resulting reduction in vested plan benefits
  - Henkel's failure to follow the special timing rule in Section 3121(v)(2) violated the plan's express terms requiring that the company "properly handle tax withholding" and caused the retirees to lose part of their vested benefit payments in violation of ERISA
- Employers should ensure that their plan documents disclaim responsibility for any negative tax consequences
- This decision raises the specter of employer liability for Section 409A violations, which can be significantly more expensive

TAX REFORM PROPOSALS

Tax Reform: General

- Last March, House Ways and Means Committee Chairman David Camp released the Tax Reform Act of 2014
- The proposal would lower individual and corporate tax rates while reducing or eliminating many deductions and credits, and also would eliminate the AMT
- The proposal is unlikely to become law and Chairman Camp has since retired, but many provisions outlined in the proposal could be enacted as part of future tax reform legislation, or as "pay-fors" in other legislation
- Other members of Congress have released similar proposals in the ensuing months

Tax Reform: Executive Compensation

- Repeal of Code Section 409A
  - Section 409A would not apply to nonqualified deferred compensation earned in future years
  - Instead, nonqualified deferred compensation would be taxed when it vests
  - Existing rights to deferred compensation would remain subject to Section 409A until 2022, or, if later, when they would become taxable under the new rules
  - Employers would continue to deduct nonqualified deferred compensation in the year in which it is taxable to the recipient

Tax Reform:
Executive Compensation

- Additional Restrictions under Code Section 162(m)
  - Performance pay would no longer be exempt from the $1 million deduction limitation on annual payments to a covered employee.
  - Once an employee became a covered employee of an employer, the employee would retain that status for all future payments, including payments made following the employee's termination of employment or death.
  - CFOs would again become covered employees.

Tax Reform: Fringe Benefits

- Limitation on Deduction of Entertainment Expenses
  - Employers could no longer deduct entertainment expenses, except to the extent the expense is included in the employee's income.
  - This means, for example, that the deduction limitation for entertainment flights on employer-provided aircraft would be extended to all individuals.
  - The proposal also would curtail employer deductions for de minimis and qualified transportation fringe benefits.
- Repeal of Exclusion for Education Assistance Programs
  - The proposal would repeal Code section 127, which permits the exclusion of employer-provided education assistance benefits of up to $5,250 per year.
  - Such benefits could be excluded only to the extent they qualify for the (narrower) exclusion for working condition fringe benefits.
- Smaller Exclusion for Employer-Provided Parking/Mass Transit Benefits
  - The proposal would limit the exclusions for parking and mass transit/vanpooling benefits to $250 and $130 per month, respectively, and would repeal the exclusion for qualified bicycle commuting expenses.

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